

With regard, first, to the longer-run monetary and debt ranges for 1984, the principal issue for the Committee appears to be whether to retain or raise the current ranges for M3 and credit. There seems no reason, on the basis of recent experience, to alter the existing ranges for M1 and M2.

Unless the economy slows down considerably more than expected, there seems to be little chance for credit growth in 1984 to fall within the Committee's existing 8 to 11 percent range. We currently anticipate that total debt will grow at a 12-1/2 percent or so rate this year. Roughly half of the overage can probably be attributed to mergers, which are estimated to add about one percentage point to growth in the first half of the year but are assumed to slow considerably in the second half. Mergers also might be viewed as contributing some to the relatively rapid growth of M3, though it's quite conjectural to determine how banks would otherwise have behaved in the absence of mergers. Our current estimate for growth of M3 this year is about 9-1/2 percent.

The upper limits of the alternative ranges suggested for M3 and debt for 1984 in the blue book would barely, if at all, encompass the staff's current projections for these aggregates. If the Committee were interested in ranges that had greater odds on encompassing actual growth, those ranges would need to be even higher, by 1/2 point or more. But any adjustment in ranges would have to balance the disadvantages of giving signals that might be construed as undue relaxation of restraint in face of an unexpectedly strong economy against the advantage of accommodating to special factors distorting the credit picture, such as mergers. Under present conditions, retaining the present ranges for debt and M3, but

perhaps indicating that actual growth may be somewhat higher because of merger activity, has a good deal to be said for it. It would have less chance, as compared with an increase in ranges (particularly a sizable increase) of being misinterpreted at this time as signalling a more accommodative posture by the Committee as the still large federal budget deficit and expanding private credit demands come increasingly into conflict.

With respect to the tentative ranges for 1985, arguments are of course strong for continuing with the process of reducing the ranges over time to rates eventually consistent with reasonable price stability. There do not appear to be special factors arguing for an increase in ranges, or even perhaps unchanged ranges--unless one has the expectation that market interest rates will drop sharply next year. In that case, there would be the real possibility that M1 growth would need to accelerate to accommodate to shifting public demands as NOW accounts again become relatively attractive outlets for savings as compared with market instruments and time deposits. However, as of now, the staff has little expectation that interest rates will be lower next year than this; indeed, the odds are rather tilted the other way.

Assuming the Committee wishes to continue with the process of reducing targets for the aggregates, the pace of deceleration will depend on judgments about the degree of resistance to upward price pressures that will produce an over-all satisfactory economic result, taking account of the need to maintain economic growth and, to put it a bit crudely, to keep a full blown liquidity crisis at bay. There are two reasons that argue for a quite gradual deceleration of money growth in the face of fairly substantial upward price pressures. First, a large deceleration of money

might entail an excessive shock to the economy; and second, a modest deceleration in money when prices are tending to move up will in any event entail substantial restraint since growth in real money balances will decelerate considerably more than nominal money and real money balances may even actually decline.

But looking to 1985, the most surprising element in the background is the lack of signs so far of a substantial upsurge of inflationary pressures. The staff projection of GNP does entail an acceleration of price increases, but it is fairly moderate. In any event one might well argue that the present favorable price climate presents an opportunity to make a marked downward adjustment in the ranges for 1985, or to reinforce whatever abatement of inflationary psychology in labor and product markets that may be keeping upward price and wage adjustments to quite modest proportions.

The largest reduction in ranges for next year suggested in the blue book is 1/2 percentage point. Somewhat larger reductions would not be inconceivable if one were to accept something like the preceding argument. The alternative of narrowing the M1 range from the present 4 to 8 percent to 4 to 7 percent by reducing the upper limit by a full percentage point might be construed as involving a somewhat stronger move than simply lowering the upper and lower limits by 1/2 point. The upper limit of the M1 range has been, on recent experience, more binding, so that such a move might send a stronger signal, even though its midpoint is no different from that of an alternative 3-1/2 to 7-1/2 percent range.

There are in addition arguments for narrowing the M1 range so that it is at least no wider than the ranges for other aggregates. Over

the past year, its behavior has been much less deviant in relation to income than was the case in 1982 and early 1983. Thus, a narrowing in the range would represent an acknowledgment of a return to something akin to "normality"--or at least acknowledgment that M1 as an aggregate, or guide, has become no less uncertain than other aggregates.

Finally, Mr. Chairman, I should mention that discussion of monetary policy solely in terms of the money and debt aggregates does seem a bit abstract at a time like this, when financial markets are quite volatile, when large banks are subject to severe strain because of, among other things, the international debt crisis, and when thrift institutions are again on the verge of unprofitability. That environment seems to argue for a continued judgmental approach to the implementation of monetary policy, though perhaps at the moment with a little more confidence in the signals being generated by M1. Thus, it appears important to continue with the short, one sentence paragraph in the directive that indicates the aggregates need to be considered in relation to behavior of the economy and conditions in domestic credit markets.

Notes for F.O.M.C. Meeting  
July 16, 1984

Sam Y. Cross

At the time of the last FOMC meeting, the dollar was in one of its temporary downturns. In the wake of the Continental Illinois' funding crisis, the exchange market became concerned about the possible vulnerability of large U.S. banks and particularly those with large Latin American exposures. These concerns and the perceived emergency aid provided to Continental by U.S. monetary authorities led the exchange markets to question the ability of the monetary authorities to pursue a tight or even firm monetary policy.

On the Thursday following your last meeting, rumors that several banks were experiencing liquidity problems spread like wildfire through the Eurodollar and domestic markets. The dollar fell sharply, exchange market conditions became quite disorderly, and we intervened, selling \$135 million equivalent of German marks, to contain these pressures and restore more normal trading conditions. By the next day the markets, while still nervous, had stabilized somewhat though the dollar continued to slip for a couple of weeks.

In early June, however, the dollar abruptly reversed direction and began an increase which has continued for most of the period since. A firming of the U.S. short-term interest rates persuaded traders that the authorities would

be able to handle the repercussions from Continental's problems without jeopardizing monetary policy. At the same time, fears of an aggressive Latin American debt cartel were diminished by the moderate results of the Cartagena meeting, and a more positive outlook developed for Mexico. A clarification of U.S. accounting procedures for non-accruing loans also helped to clear the air and signaled to the markets that the authorities felt confident that the banks could sustain the adverse impact on their earnings. Generally, these developments were seen as allowing U.S. authorities to resume or continue a firm monetary policy, and continued evidence of vigorous economic expansion gave further reason to expect that monetary policy would indeed be firm.

The dollar has also been boosted by lower-than-expected increases in consumer and other prices. A drop in the price of gold since early June that got as large as 14 percent suggests a downward revision in expectations of U.S. inflation. This, together with the strong economy and advantageous interest rate differentials, appears to have stimulated investor interest in the dollar. Moreover, the imminent repeal of withholding tax on interest paid to foreigners has caused talk of increased foreign investments in U.S. Treasury and U.S. corporate securities, although as yet the impact of this move is difficult to assess.

The dollar may also have obtained some support from investors to the extent that the alternatives to the dollar were seen as not very attractive. Strikes and labor unrest

in several European countries, as well as slower than expected growth and low interest rates, cast a pall over European currencies, while uncertainty about oil supplies in the Gulf reminded investors of Japan's heavy dependence on imported oil. The German metalworkers' strike, which hung over the mark for the many weeks, was finally settled, but doubts about the impact of the settlement on the economy persist and so far the mark has not responded positively.

Foreign monetary authorities reacted in different ways to this latest rise of the dollar, some intervening, others raising interest rates and a few doing both. The Bundesbank has stated that mark interest rates have been decoupled from U.S. interest rates. Since early 1984 short-term rates for the mark have remained essentially unchanged, as the recent 1/2 point hike in the discount rate was primarily a technical adjustment. Nonetheless, the Bundesbank has intervened in size since your last meeting, selling \_\_\_\_\_ to support the mark. Moreover, other EMS central banks, in conjunction with the Bundesbank, purchased an additional \_\_\_\_\_ equivalent of marks. In the same period Canada also intervened somewhat more than usual and, in addition, had to raise its interest rates by more than the increase in U.S. interest rates. The Japanese also intervened, but modestly, in support of the yen before it hit new lows for 1984 against the dollar. The Bank of England shied away from any heavy intervention to support the pound, but it has had to accept a substantial rise of

interest rates of almost 3 percentage points in the last ten days in response to exchange market pressures on sterling. The Swiss authorities stood on the sidelines and the Swiss franc depreciated not only against the dollar but also against the mark.

To conclude: now in mid-July, the dollar is trading on average significantly above the earlier peak in mid-January. Factors which earlier in the year were expected to weaken the dollar--e.g., that U.S. economic expansion would peter out, that inflation would revive, that the current deficit would force the dollar down, that monetary policy would be accommodating in an election year--have not had that effect. Still, the present strong dollar is at least in part sustained by large interest rate differentials, which have increased by 200 basis points or more in many cases from the differentials existing at the dollar's earlier peak in January.

PAUL MEEK  
FOMC NOTES  
JULY 16-17, 1984

Open market operations over the past eight weeks have taken place within the context of monetary aggregate behavior broadly in line with the Committee's desires. M1 was to the strong side from March to June, growing at 8 percent versus the 6-1/2 percent rate expected. For a time, growth in M2 and M3 also seemed likely to exceed the Committee's expectations, but their growth moderated to bring them out quite close to the 8 and 10 percent rates anticipated. RPs declined as bank underwriting positions fell with higher interest rate expectations. Term Eurodollar liabilities also declined, presumably as money market funds and other U.S. investors allowed holdings to run off after the exodus of funds from Continental in May.

The timing and magnitude of Desk operations during the interval were significantly affected by changing bank behavior related to the Continental Illinois situation and market concerns about bank loans to Argentina and other Latin American countries. Investors were preoccupied with credit quality, as evidenced by a widening of the spread between 3-month CDs and Treasury bills to about 160 basis points at one point. Banks became increasingly concerned about liquidity as the quarter-end statement date approached. The large banks switched to accumulating reserve surpluses, after having previously run reserve deficiencies in the first week of their settlement period since CRR began. The market shift in demand patterns crested in the first half of the July 4 period when excess reserves rose to \$2.4 billion with \$1.8 billion of this held by large banks.

Against this background, open market operations sought to provide flexibility for liquidity needs without relinquishing the desired degree of pressure on the banks to borrow at the window. On occasion, the Desk more than met the projected reserve need in the face of insistent bank bidding for reserves that was pushing the federal funds rate above the 11-1/2 percent upper limit of the Committee's consultation range. The Desk was prepared to absorb reserves later that became redundant, but in the July 4 period, in particular, the reserves market remained under pressure until very late in the final day.

Whereas nonborrowed and excess reserves ran above planned levels in two of the four settlement periods, discount window borrowing remained remarkably close to the Committee's desired \$1 billion level, tracking Continental's borrowing as extended credit. There was, however, a build-up in money market pressure as the major banks not only sought to accumulate excess reserves but also shied away from borrowing at the Federal Reserve. The federal funds rate, which averaged 10-1/2 percent in the June 6 statement period moved up to range around 11 and 11-1/4 percent in the past six weeks. Contributing to the precautionary and seasonal pressure was the belief that the strength evident in the economy probably warranted a lasting increase in the funds rate even after seasonal pressures subsided.

In the present reserve period, the major banks seem to be relaxing somewhat, willing once more to accumulate reserve deficiencies in the first week of the period. Market participants also appear to be lowering their expectations for interest rates. It seems quite possible that the federal funds rate associated with \$1 billion of borrowing could recede toward the 10-1/2 to 10-3/4 percent level prevailing before June.

Operations over the period were complicated at times by greater-than-usual difficulties in projecting reserves. The Treasury's balance bounced around quite a bit toward the end of the quarter, and Continental's borrowing at the window was also variable. The Desk bought \$1.4 billion of Treasury bills from foreign accounts, mostly by early June. We used System and customer-related RPs on sixteen occasions. A rise in Continental's borrowing from the \$2 billion level to \$4.5 billion provided most of the pre-holiday need for reserves. I should mention that our phasing out of RPs on bankers' acceptances took place on July 2 on schedule without significant market comment or difficulty for Desk operations.

Investor uneasiness about bank paper became pervasive during the period. Anxiety about Argentine and other loans added to the nervousness touched off by the flight of funds from Continental in May. There was no wholesale selling of paper into the secondary market as occurred after Penn Square in mid-1982. But money market funds and others apparently did redirect funds toward Treasury bills and industrial commercial paper as well as increasing the representation of regional and foreign banks in their portfolios before June 30. Continental experienced a further run off. Major banks generally relied on writing short-term CDs and commercial paper directly with customers to tide them over the statement date. Most major banks had to work harder to cover their expanding loans. The rate spread between CDs and bills widened to 160 basis points in late June, almost 100 basis points above the level of early May. This increase in costs figured in the prime rate rise to 13 percent on June 25.

A modest tiering of rates developed in the markets for bank paper. The standing of Japanese and regional banks improved, while

Manufacturers Hanover paper has been trading in the secondary market at 10 to 15 basis points above the rates on the top banks because of its large exposure to Argentina. The money market has calmed considerably and expectations of further rate rises have diminished. The spread between 3-month CDs and Treasury bills has fallen to about 130 basis points. The worst seems to be over, although tiering remains. CD rates were up 45 to 85 basis points over the period.

The market for Treasury securities underwent several marked changes of mood over the interval between meetings, with yields closing 15 to 40 basis points higher through four years and 20 to 35 basis points lower at the long end. Investor demand kept rates on short-dated Treasury bills insulated from the rise in the federal funds rate for much of the period. But rates in yesterday's 3- and 6-month auctions were about 20 basis points higher than those of eight weeks previously.

In the note and bond market, sentiment was extremely gloomy in late May as participants worried about Treasury financing, a vigorous economy, and strong credit demands, as well as the ability of international debtors to repay loans. Yields on issues of seven years and beyond rose 50 to 60 basis points from the meeting to the vicinity of 14 percent. However, the sale of the Treasury's 5-year two-month note on May 30 precipitated a rush of investor buying and yields tumbled quickly. They remained below the end-of-May highs even when the rally faltered on the flash report of unexpected strength in real GNP and on the approach of the Treasury's \$15.5 billion end-of-quarter financing. More recently, investors have been encouraged by the decline in gold and commodity prices as well as the repeal of withholding on interest income earned by foreigners. An improved inflation outlook undergirds broader investor participation. Some

have also concluded that the Federal Reserve may not soon increase the pressure on banks or raise the discount rate. Dealers, which operated with sizable net short positions through most of the period, have worked to cover those in the past 10 days, fueling a strong rally. With coupon stripping helping depress the yields on longer issues, the yield curve now has a modest downward tilt from about 7 years out.

Corporate bond yields have moved roughly parallel with Treasuries over the period. New issue activity has been light with bank holding companies prominent among the issuers, selling \$1.4 billion of notes. Municipal offerings were not heavy until two weeks ago when the final tax package spurred a flow of mortgage financing bonds. Yields on these issues rose sharply initially but dropped back later on strong demand to close only slightly higher for the period.

I should like to report that the ongoing discussions with the Primary Dealer Committee of the Public Securities Association have resulted in the Group's endorsement in principle of the promulgation of capital adequacy guidelines, applying to their membership as well as to other dealers. Discussions are continuing to refine the technical aspects of the guidelines.